OFFICE OF CITY CONTROLLER

CITY OF HOUSTON
INTER OFFICE CORRESPONDENCE

To	Mayor Bill White City Council Members	**From**	Annise D. Parker City Controller
		Date	October 30, 2004
		Subject	**September 2004 Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending September 30, 2004.

GENERAL FUND

We are currently projecting a $23 million shortfall for the general fund in FY05, an increase of $1.9 million from August 2004. Although the second sales tax check for the fiscal year showed a 13% increase over last year, we are currently showing no change to the bottom line in general fund revenues, as it is too soon to predict that this trend will continue.

General fund expenditures in General Government have increased by approximately $1.9 million as follows:

- Estimated debt service interest expense increased by $1.2 million to reflect actual expenses for the TRANS borrowing and interest expense on an anticipated supplemental borrowing.
- Based on figures from Harris County, election costs are estimated to be $600,000 more than originally expected.
- The Mercer Pension Contract for $69,000 was not part of the original budget.

ENTERPRISE FUNDS

There are no changes this month in our projections for Aviation and the Combined Utility System Fund.

For C&E, we are projecting a $754,000 decrease in parking revenues primarily due to HPD no longer having a contract in the Fannin Garage. In addition, there was an increase of approximately $0.5 million in other revenues to reflect a prepayment for the Toyota garage. Lastly, there was an increase in Capital Outlay of $100,000 (and an increase in interfund transfers) for park enhancements to Root Memorial Square.

COMMERCIAL PAPER AND BONDS

The City's practice has been to maintain no more than 20% of the total outstanding debt for each type of debt in a variable rate structure. At month-end, the ratio for each type of outstanding debt was:

General Obligation	22.7%
Combined Utility System	18.0%
Aviation	17.1%
Convention and Entertainment	27.4%

Mayor Bill White
City Council Members
September 2004 Monthly Financial and Operations Report

SWAP REPORT

The City's Swap Policy specifies that the City will track and report on the financial implications of its swap agreements on a quarterly basis. The report is to include a summary of key terms of the agreements, mark-to-market value, exposure to counterparties, credit ratings of counterparties or guarantors, and any collateral posted as a result of the Swap agreements. The report for September 30, 2004 is included as an attachment to this letter.

Respectfully submitted,

Annise D. Parker

Annise D. Parker
City Controller

City of Houston, Texas
Swap Agreements Disclosure
September 30, 2004

I. General Obligation Swap

On February 20, 2004 the City entered into a basis swap referred to as a "synthetic reduced variance coupon swap" with RFPC, LLC ("RFPC" or "the Counterparty"). This swap was a negotiated transaction.

Objective. The objective of the swap is for the City to reduce its fixed rate debt service costs through a swap structure that takes on basis risk.

Terms. The City will pay a variable rate and receive a fixed rate of return on a notional principal value of $200,000,000, with the underlying bonds being various maturities of PIBS issued between 1998 and 2002. The City pays an amount equal to 5% plus the tax-exempt market standard BMA Index rate divided by .667 minus the taxable six-month US Dollar LIBOR rate minus a constant of 69 basis points, up to a maximum of 10%. The City receives a fixed rate of 5% from RFPC. Because the two 5% fixed rates offset one another, the City is effectively making payments based on BMA and receiving payments based on LIBOR plus a fixed spread. The variable rate is fixed for each budget period. The agreement is effective from March 1, 2004 to March 1, 2025. Starting in fiscal year 2017, the notional value of the swap declines as the principal amount of the associated debt is repaid in varying amounts until the debt is retired in 2023. Based on the initial agreement, the City will receive its first payment of $500,000 on March 1, 2005. After that date a payment will be received or made every six months based on the indexes for the prior budget period.

As of September 30, 2004 the swap created a synthetic variable-rate exposure as follows:

	Terms	Rate (%)
Variable rate payment to counterparty	Fixed Rate	5.0000
	BMA/0.667	1.5993
	-LIBOR	-1.1600
	-Constant	-0.6900
	Subtotal	4.7493
Fixed rate payment from counterparty	Fixed	5.0000
Net interest rate swap receipt (payment)		0.2507

The average rate for the underlying PIBS bonds is 5.19%. This swap reduces the effective rate by 0.2507% to 4.9393%.

Fair value. The fair value of the swap was negative $1,954,000 as of September 30, 2004. The value was calculated using the zero coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of September 30, 2004, the City was not exposed to credit risk because the swap had a negative fair value. However, if interest rates change and the fair value of the swap becomes positive, the City will be exposed to credit risk on the swap in the amount of its fair value. RFPC has not been rated by the rating agencies. To mitigate this potential credit risk for an unrated counterparty, the City required RFPC to purchase a surety bond from Ambac Assurance Corporation, a AAA rated insurance company. The City's obligations under the swap are also insured by Ambac. Should Ambac's rating decline in the future, RFPC will be required to post collateral for the City's benefit.

Interest rate risk. The City has an exposure to interest rate risk because it is paying a variable rate on the swap. However, this risk is mitigated because the payment formula has a BMA-based variable component that is offset by subtracting a LIBOR variable component.

Basis risk. The City is exposed to basis risk based on changes in the relationship between the taxable six-month US Dollar LIBOR index and the tax-free BMA index. The City entered into the swap in anticipation of savings that would be produced based on the historical trading patterns of BMA and LIBOR in different interest rate, tax, and economic environments over the past two decades. If, however, future trading patterns prove to be significantly different from historical ones, the City's anticipated savings could fail to materialize, and it could be exposed to additional costs. Among the factors that could cause this trading relationship to change would be a major reduction in marginal income tax rates, repeal of the tax-exemption for municipal bond interest, or other changes in federal policy that would reduce the benefit that municipal bonds currently enjoy in comparison to taxable investments.

Termination risk. The City may terminate the swap for any reason. RFPC may terminate the swap if both the City and the City's insurer fail to perform under the terms of the contract. If the swap has a negative fair value at the time of termination, the City will be liable to RFPC for that payment. The City's termination risk is significantly mitigated by a provision in the swap agreement that allows the City to make the termination payment in equal annual installments from time of termination up to the termination date of the agreement in 2025.

II. Combined Utility System Swaps

On June 10, 2004 the City entered into three pay-fixed, receive-variable rate swap agreements with identical rates. The City pre-qualified six firms to submit competitive bids on the swap. The bidding took place on June 7, 2004. The three firms selected all matched the lowest fixed rate bid of 3.7784%.

Objective. The objective of the swaps is to protect against the potential of rising interest rates in conjunction with the City's Combined Utility System 2004B auction rate variable interest bonds ("2004B Bonds") and to achieve a lower fixed rate than the market rate for traditional fixed rate debt at time of issuance of the 2004B Bonds.

Terms. The notional amount of the swap agreements totals $653,325,000, the principal amount of the associated 2004B Bonds. The City's swap agreements contain scheduled reductions to outstanding notional amounts that follow anticipated payments of principal of the 2004B Bonds in varying amounts during the years 2028 to 2034.

Under the terms of the swaps, the City will pay a fixed rate of 3.7784% (lower than the rate for fixed rate debt at time of issuance) and receive a floating rate equal to 57.6% of One-Month US Dollar LIBOR plus 37 basis points. All agreements were effective June 10, 2004, the date of issuance of the 2004B Bonds. The termination date is May 15, 2034.

At September 30, 2004, the effective rate on the bonds associated with the swap was computed as follows:

	Terms	Rate (%) Received/ (Paid)
Variable rate payment from counterparties	LIBOR x 57.6%	1.0138
	+ Constant	0.3700
		1.3838
Fixed rate paid to counterparties	Fixed	(3.7784)
Net rate (paid)/received for swap		(2.3946)
Average variable rate in effect on 2004B bonds		(1.4243)
Plus dealer and auction fees on 2004B bonds		(0.2530)
Effective rate of 2004B bonds		(4.0719)

In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds, which have a comparable maturity, was 5.0795%.

Fair value. Because interest rates have declined, the swaps had a negative fair value of $45,775,000 as of September 30, 2004. This value was calculated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of September 30, 2004, the City was not exposed to credit risk because the swaps had a negative fair value. However, should interest rates increase and the fair value of the swap become positive, the City would be exposed to credit risk on the swap in the amount of its fair value. The City's swap policy generally requires that swap counterparties be rated double-A or better by at least one nationally recognized rating agency. As of September 30, 2004, the ratings of the three swap counterparties all met this standard (see below). Also, under the agreements, if a counterparty's credit rating falls below double-A, collateral must be posted in varying amounts depending on the credit rating. No collateral has been required to date.

Counterparty	Notional Amount	Fair Value	Counterparty Credit Rating (Moody's /S&P /Fitch)
Goldman Sachs	$353,325,000	$ (24,761,000)	Aa3 /A+ /AA-
Bear Stearns Capital Markets	150,000,000	(10,507,000)	AAA / AAA / --
UBS AG	150,000,000	(10,507,000)	Aa2 /AA+ /AA+
TOTAL	$653,325,000	$ (45,775,000)	

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. The City has issued tax-exempt auction rate bonds with an average rate of 1.4243% (not including dealer and auction agent fees) as of September 30, 2004, whereas the associated LIBOR-based rate of the swap was 1.3838%.

Termination risk. The City may terminate for any reason. A counterparty may terminate a swap if the City fails to perform under the terms of the contract. The City's on-going payment obligations under the swap (and to a limited extent, its termination payment obligations) are insured, and counterparties cannot terminate so long as the insurer does not fail to perform. If a swap should be terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if at the time of the termination the swap has a negative fair value, the City would be liable to the counterparty for a payment equal to the swap's fair value.